

OBSERVATIONS

CARES Act – Business Tax Provisions 6

April 8, 2020

The Paycheck Protection Program (PPP) of the CARES Act is in the process of being implemented by banks. The process has been somewhat rocky for several reasons, including the different releases by the Treasury Department and the Small Business Administration, concerns by banks about the impact of existing banking statutes and the gaps in the statutory language.

Today's topic will address questions regarding the forgiveness of loan. Specifically, we will review the rules that calculate how much of the loan can be forgiven. A subsequent blog will address the process of forgiveness.

Please be aware that the Act and our interpretation are subject to any administrative interpretation issued by the Small Business Administration. We have already seen such administrative interpretations during the application process.

Section 1106 of the CARES Act¹ addresses the loan forgiveness.

What May Be Forgiven

The amount that may be forgiven is the sum of the following;

1. Payroll costs
2. Any payment of interest on any covered mortgage obligation (which shall not include any prepayment of or payment of principal on a covered mortgage obligation)
3. Any payment on any covered rent obligation
4. Any covered utility payment²

However, these costs must be “incurred and payments made during the covered period.”

The term “covered period” is defined as “the 8-week period beginning on the date of the origination of a covered loan”.³

At least 75% of the loan amount must be used for payroll costs.

¹ Act Sec., 1106, page 41

² Ibid, 1106 (b), page 43

³ Ibid, 1106 (a)(3), page 41

We have noted three potential issues.

1. What is the origination date? The Act does not define the term origination date. Presumably, it would be the date the funds are available to the borrower (although there is no statutory language to that effect). This will put a burden on the borrower to be prepared to make expenditures immediately.
2. The conflict between “weeks” and “months”. The covered period is measured as 8 weeks. However, many expenses are monthly. Will 2 months of rent have to be prorated into 8 weeks? There is statutory language about the relationship between pay periods and months for determining full-time equivalents (see below), however there is no language that provides guidance in this area.
3. The definition of “incurred and payments made.” Generally, costs are incurred in one period but paid in another. For example, a payroll period may cover 2 weeks and payment be made in a third week. A strict interpretation would require that the cost be both incurred and paid in the 8 week period. However, that clearly would cut the number of weeks of actual expenses significantly. We will need administrative guidance to determine whether the SBA will look to the incurred (accrual) dates or the payment dates.

Defining Costs

Payroll costs are discussed below. The other allowable costs are interest, rent and utilities.

Interest: Interest is an allowed cost if the debt is a “covered mortgage obligation”⁴, which means that it is a debt obligation that satisfies 4 conditions:

1. It arose in the ordinary course of business
2. It is a liability of the borrower
3. It is a mortgage on real or personal property, in other words any secured debt; and
4. was incurred before February 15, 2020

Rent: The term “covered rent obligation” is defined as rent obligated under a leasing agreement in force before February 15, 2020.⁵

Utilities: the term “covered utility payment” is defined as payment for the following services:

- electricity
- gas
- water
- transportation
- telephone, or
- internet access

The service must have begun before February 15, 2020.⁶

⁴ Act Sec, 1106 (a)(2), page 41

⁵ Act Sec, 1106 (a)(4), page 42

⁶ Act Sec, 1106 (a)(5), page 42

Payroll Costs-Overview

The principal purpose of the Act is the preservation of jobs and therefore it is not surprising that the provisions regarding payroll costs are the most complex. If the loan principal is used for allowable costs, the amount of the loan that is forgiven may nonetheless be reduced if certain payroll conditions occur.

There are two potential reductions in the amount of loan that will be forgiven:

1. Number of employee reduction
2. Amount of wages reduction

Despite these conditions, loan reduction may be avoided if the business engages in certain re-hires.

Number of Employee Reduction

If there has been a reduction in the employee body count, there may be a portion of the entire loan (not just the loan allocated to payroll) that is not forgiven.

The reduction is a fraction calculated as:

$$\frac{\text{Average number of full-time equivalent employees per month during the covered period}}{\text{Average number of full-time equivalent employees per month during a prior period}}^7$$

Therefore, if the employer has 30 employees in the covered period and 40 employees in the prior period, then 75% of the costs would qualify for forgiveness.⁸

The covered period is 8 weeks beginning with the date of the loan origination.

The borrower is given an election to choose as the prior period either:

1. February 15 to June 30, 2019 or
2. January 1 to February 29, 2020

Presumably the borrower will select the period with the lowest average number of full-time equivalent employees per month.

In determining the number of employees per month, the borrower calculates the average number of full-time equivalent employees for each pay period falling within a month. There is no definition of 'falling with a month'. Presumably it would be a pay period ending in the month or having the most number of working days in a month.

There is no definition of full-time equivalent employee within the Act. For purposes of administering Affordable Care Act, the SBA has previously defined a Full-Time Equivalent (FTE) Employee as "a combination of employees, each of whom individually is not a full-time

⁷ Act Sec, 1106 (d)(2), page 45

⁸ The statutory language is cumbersome in this area but the intent is clear.

employee because they are not employed at least 30 hours per week, but who, in combination, are counted as the equivalent of a full-time employee.”⁹

Given there is no guidance in the Act, this definition may not apply, and it may mean the number of hours worked in the pay period divided by the number of hours that the employer defines as fulltime.

Amount of Wages Reduction

If the wages paid to an employee in the covered period (i.e. the 8 week period) are reduced by more than 25% compared to the prior payroll quarter, then the reduction in excess of 25% will not be eligible for forgiveness.¹⁰ However, there are a number of questions with this provision.

First, it applies only to employees “who did not receive, during any single pay period during 2019, wages or salary at an annualized rate of pay in an amount more than \$100,000.” Thus, reductions to employees who earn over \$100,000 are not included. However, this definition refers to an annualized rate in any single pay period. Therefore, an employee who earns \$60,000 per annum at the rate of \$5,000 per monthly pay period, but receives a \$6,000 bonus in a pay period, would have a single pay period which reflects more than \$100,000 annually and so apparently would not be included in the wage reduction calculation.

Second, assuming all loans are issued in the April, the measurement period would appear to be January 1 to March 31, 2020 (the prior payroll quarter).

Third, it refers to payments to an employee. On the face of it, if Employee A works January 1 but leaves in late March, there would be a reduction for 75% of Employee A’s wages. However, Employee B’s wages (who was hired to replace Employee A), would not qualify. An employee by employee tracking would appear to be very cumbersome and potentially very unfair.

This is an area where we can expect significant administrative guidance.

Re-Hires

There is a provision that if, in the period February 15 to April 26 (30 days after enactment), an employer has a reduction for either a decline in full time equivalents or in the amount of wages, this can be cured by rehiring a laid off employee or eliminating the redacted wages. The time period for cure ends June 30.¹¹

It appears that this cure would apply if accomplished by June 30, without any retroactivity. In other words, if employees are re-hired on June 25, then they will be counted in the 8 week period. Again, this is an area requiring administrative guidance.

⁹ https://www.sba.gov/sites/default/files/files/SBA_ACA101_Deck.pdf

¹⁰ Act Sec, 1106 (d)(3), page 47

¹¹ Act Sec, 1106 (d)(5), page 47

Final Note

If the loan is not forgiven, then the borrower is required to repay the loan. Although the Act provides for interest of up to 4% per annum and a term of 10 years, the SBA guidance specified 1% per annum and a term of 2 years.¹² Therefore, the unforgiven amount would accrue interest at 1% and would have a 2 year term. The Act provides that loan payments, including interest and principal are suspended for at least six months¹³, so in month 7 the borrower begins an 18 month loan repayment. It is imperative that borrowers request forgiveness before the six months has expired.

Given the complexity of the requirements and the importance and value that can be achieved by having procedures in place for compliance, we encourage clients to have strict and detail accounting procedures for the covered period. Please contact us for assistance.

We will be providing further blogs as information becomes available.

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¹² Ibid page 25 and SBA Interim Final Rule page 12.

¹³ Ibid page 26